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EDITORIAL

Starting the Regulatory Work

The financial crisis is now more than a year old. It intensified through an entire presidential campaign and has persisted during the postelection transition. And yet, less than two weeks from Inauguration Day, it is still unclear what President-elect Barack Obama has in mind when he promises “a 21st-century regulatory framework.”

The outlines of the challenge are clear. The decades-old ways — in which the Treasury and other federal regulators have relied less on rules and enforcement and more on faith in market discipline to limit risk to the system — have been a manifest failure. Anything less than a new rules-based regime would be inadequate to the task of restoring confidence and, eventually, reviving the economy. Even more basic, any new regime must be founded on a declared desire and willingness to regulate.

Will Mr. Obama deliver? Without a clear signal from the president-to-be, the early signs are not terribly encouraging. There are no prominent consumer or investor advocates among his top economic advisers. Except for Paul Volcker, the former Federal Reserve chairman, there are no officials or regulators, past or present, who have distinguished themselves by giving early warning of the impending catastrophe or taking strong action against the excesses that were fueling it.

Mary Schapiro, Mr. Obama’s choice to lead the Securities and Exchange Commission, has served ably in government and industry regulatory positions, but is best known for her support of self-regulation and a greater role for principles-based regulation — basically, the opposite of clear rules. The choice of Gary Gensler to lead the Commodity Futures Trading Commission, which regulates futures contracts, is more troubling.

Mr. Gensler, a former investment banker from Goldman Sachs, one the biggest brokers of commodities, was an assistant Treasury secretary under President Bill Clinton. In 2000, he oversaw the drafting of legislation that exempted derivatives from oversight by the federal commodity regulator, including the viral credit default swaps that have amplified the current crisis. Swaps and other derivatives must be regulated. The country needs an exchange where they are openly traded and subject to the full range of regulatory scrutiny.

Ultimately, new laws for trading derivatives must be enacted by Congress, but the input of the main regulator of the commodity exchange will be important in writing and implementing the laws. Where does Mr. Gensler stand? How do his close ties to Wall Street affect his choices, his sense of what is right and what is needed? Those are among the questions that senators have to ask him at his confirmation hearing.

They will need to ask similar questions of Timothy Geithner, Mr. Obama’s choice for Treasury secretary. As

the president of the New York Federal Reserve Bank since November 2003, Mr. Geithner was the closest regulator to Wall Street during the years when many of the excesses that led to the crisis proliferated in plain sight.

One early sign of how serious the Obama administration is about regulatory reform will be whether officials try to couch it primarily in terms of revamping the structure of regulation. There are too many regulators with overlapping demands and authority, but a new structure must derive from new rules, not vice versa.

In addition to explicit regulation of derivatives, those rules must include limits on the amount of money that financial institutions can borrow in order to boost returns — and higher requirements for the amount of capital they must hold to support their activities and cushion their losses. A wise regulatory regime would require institutions to build up capital in good years so that they can husband their resources in lean years.

And in addition to regulating previously unregulated investment instruments, Washington must impose regulations on equally unregulated hedge funds. There was a time when institutions that were too big to fail posed the greatest danger to the financial system and economy. This crisis has shown us that financial institutions can become so interconnected that allowing them to fail is just as dangerous. The solution is to regulate financial participants outside the formal banking system.

All that would only be a start. There is an important false assumption that must be laid to rest: that protecting consumers and individual investors unduly limits corporate profits and financial innovation. The establishment of what advocates call a Consumer Credit Safety Agency is long overdue. If a process had been in place to determine the effect on consumers of financial products and practices, the current crisis may well never have happened. Consumer advocates have long been aware of the lurking dangers in the subprime lending that sparked the debacle.

It could be that the people whose actions contributed to the mess are best equipped to clean it up. That remains to be seen. But it would be tragic if Wall Street concludes from Mr. Obama’s choices that it need not worry about the world changing in ways that would fundamentally alter its pursuit of profits. You will know the new rules are working when Wall Street starts worrying.

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